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IN THE

Supreme Court of the United States

October Term, 1966

No. 343

PRIMA PAINT CORPORATION,

Petitioner,

against

FLOOD & CONKLIN MFG. CO.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONER

AND

BRIEF FOR PETITIONER IN OPPOSITION TO THE MOTION AND BRIEF OF THE AMERICAN ARBITRATION ASSOCIATION AS *AMICUS CURIAE*

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Statutes Involved

The statutory provisions involved are printed in petitioner's brief 3-5. While the questions presented touch on this Section as originally passed, it is not readily apparent in petitioner's brief that Section 4 of the Federal Arbitration Act was amended in 1954. For the convenience of the Court, we reprint the applicable portion (Pet. Br. 4) with new matter *italized* and omitted matter [bracketed].

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for arbitration may petition any [court of the] United States *district court* which, save for such agreement, would have jurisdiction under [the judicial code at law, in

equity,] *Title 28, in a civil action* or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. Five days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by [law for the service of summons in the jurisdiction in which the proceeding is brought.] *the Federal Rules of Civil Procedure.* The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed. If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, or if the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such an issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return day of the notice of application, demand a jury trial of such issue, and upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by [law for referring to a jury issues in an equity action,] *the Federal Rules of Civil Procedure* or may

Statement of the Case

F & C's "statement" is replete with gross misstatements, artfully contrived distortions, and unwarranted assumptions, which are wholly without this Record, completely unsupported, obviously self-serving, and contradicted by Prima.

Demonstrative of respondent's impropriety is its bold presentation for the first time of a question never raised below and contrary to the rules of this Court. (Rule 40(1)(d), Point IV, *infra*).

The misstatements are exemplified by the following:

A. "Prima was aware of this filing and of the subsequent progress of the Chapter XI proceeding" (Resp. Br. 3).

B. "Prima in fact made no complaint to F & C or to any of its representatives during the pendency of the Chapter XI proceeding" (Resp. Br. 3).

C. "Prima continued * * * to avail itself of such advisory and consultative services as it desired without a hint of any grievance" (Resp. Br. 3).

D. "Prima continued, without complaint, its use of F & C's consulting services and customer lists" (Resp. Br. 4).

E. "Only on September 17, 1965 did Prima complain" (Resp. Br. 4).

F. "The complaint does not allege * * * nor does the Record anywhere indicate, that F & C's Chapter XI proceeding * * * prevented F & C from performing any of its undertakings * * *" (Resp. Br. 5-6).

G. "* * * F. & C was asked to and did actually perform its consulting function * * *" (Resp. Br. 6).

H. "* * * No claim of 'fraud' was raised by Prima until a year after the supposed fraud was perpetrated" (Resp. Br. 6).

I. "F & C is * * * no nearer to resolution of the controversy created by Prima" (Resp. Br. 8).

A hearing below would have developed that Prima was never a creditor of F & C, received no bankruptcy notices, and therefore could only have been aware of such subsequent proceedings as actual knowledge on its part can be shown, and that Prima sought relief in the Bankruptcy Court as early as February 19, 1965. Some of Prima's grievances with respect thereto were in fact communicated to F & C (R. 28-30). F & C's performance of its consulting function is wholly unsupported by the Record, except for a self-serving statement contained in Paragraph 8 of the affidavit of F & C's attorney (R. 17), who obviously never had, nor could have had any personal knowledge of what occurred during the Receiver's administration.

Finally, any resolution of which party created this controversy still remains an undetermined question of fact.

F & C's statement is rife with speculations, distortions and assumptions, and by the posing of factual issues admittedly establishes the necessity of a hearing, as illustrated below:

J. "Presumably, Prima intends * * * the nine other breaches * * * will be resolved by arbitration" (Resp. Br. 6).

K. "Prima * * * continued * * * to avail itself of the consulting services of Mr. Jelin" (Resp. Br. 7).

L. "Prima was obviously not prejudiced * * * *" (Resp. Br. 7).

M. "In none of the papers * * * did it (Prima) attempt to explain how F & C's financial condition was in any way material * * * *" (Resp. Br. 6).

After reversal and remand of this matter, these barren allegations will be dissipated with dispatch.

POINT I

The instant agreement does not evidence a transaction involving interstate commerce.

F & C admits that:

> "Prima's reliance, perforce, was on the customer lists, on the agreement of F & C not to compete, and on the availability of Jerome K. Jelin to render consulting services." (Resp. Br. 6)

The customer lists, were to be used solely for the computation of payments for F & C's employment (Consulting Agreement, Par. 4(a), R. 22). The agreement was merely one of employment between the parties, with the usual covenant not to compete. Not by any stretch of the imagination, can this be considered a contract evidencing a transaction in interstate commerce.

Prima's president is quoted as stating that the agreement "contemplated and intended an orderly transfer of the assets * * * of" F & C (Resp. Br. 14, R. 40-41). This

statement does not concede the transaction involved interstate commerce. The reference to "assets" can only mean those set forth in the agreement in dispute herein, that is, expertise and know-how (advice and consultation) and a covenant not to compete.

This agreement does not evidence a transaction in interstate commerce for all of the reasons set forth above and in Point I of petitioner's main brief.

POINT II

Congress has not created a federal right to arbitration.

No emasculation of the Federal Arbitration Act can occur by excising diversity cases from its ambit as suggested by F & C (Resp. Br. 19). Further, this court's ultimate decision, as it may affect, forum, validity of contract, and law applicable thereto, cannot possibly be characterized as an unjustifiable interference with the proper exercise of commerce powers (Resp. Br. 20).

There is no express or implied language of pre-emption of state rights set forth in the Act. Moreover, the Act does not meet any tests of "conflict", "coincidence" or "preclusion" heretofore applied as determinative by this Court in such cases (60 Harv. L. Rev. 262 (1946).

F & C's argument and its resulting legal effect (Resp. Br., Point I(B)) is contrary to all precedent as set forth in Point II of petitioner's main brief and petitioner's brief in opposition to the *Amicus, infra,* to which this Court is respectfully referred.

POINT III

Interpretation and effect of the Federal Arbitration Act is a question of state law.

Prima refutes F & C's contentions as set forth in Point II of its brief (Resp. Br. 21) and relies upon its argument in Point III of the petitioner's main brief and petitioner's brief in opposition to the *Amicus, infra.*

POINT IV

Rescission for fraudulent inducement is not referable to arbitration.

F & C admits, that as a threshold question, *Robert Lawrence* requires judicial determination of fraud in the inception of the contract (Point II, Resp. Br. 23-24).

F & C's authorities are all distinguishable both on the law and the facts. Those which are worthy of comment follow:

Neither, *Amerotron Corp.* v. *Maxwell Shapiro Woolen Co.*, 3 A. D. 2d 899, 162 N. Y. S. 2d 214 (1st Dept. 1957), *aff'd w/o opinion*, 4 N. Y. 2d 722, 148 N. E. 2d 319 (1958); nor *M. W. Kellogg Co.* v. *Monsanto Chemical Co.*, 9 A. D. 2d 744, 192 N. Y. S. 2d 869 (1st Dept. 1959); nor *Fabrex Corporation* v. *Winard Sales Company*, 23 Misc. 2d 26, 200 N. Y. S. 2d 278 (Sup. Ct. Spec. T., N. Y. Co. 1960); were found to be actions for rescission of contract for fraudulent inducement.

Amerotron was an action for *damages for fraud* (an action affirming the contract). *Kellogg* was an action for fraudulent *misrepresentation in the contract* (an action on contract). *Fabrex* involved a question of *performance of contract* (an action on contract).

Rodgers, et al. v. *Feldman & Lambeth Management Inc.*, 65 Civ. 1413, S. D. N. Y., August 24, 1965, Wyatt, J. (not officially reported, printed *infra*, Appendix A) sets forth present New York law, *unchanged* since *Robert Lawrence*. Judge Wyatt further found that the holding of *Fabrex*, cited by the Court of Appeals in the case at bar (R. 49), is either distinguishable or wrong.

The issue in *Nelley* v. *Baltimore City*, 224 Md. 1, 166 A. 2d 234 (1960), was resolved as a question of election. Finding that the plaintiff elected to finish the contract, the Court held this "latter remedy was the one actually and clearly chosen, and is, of course, an affirmance of the contract". In agreeing with *Amerotron*, as to whether the fraud alleged was arbitrable, the Maryland Court clearly presupposed that an election to affirm the contract had occurred.

The Court recognized that *Robert Lawrence* goes beyond *Amerotron*:

> "• • • for it reaches this conclusion notwithstanding disaffirmance of the contract by the party claiming to have been defrauded. That, we repeat, is not the situation before us. Patapsco clearly elected to affirm the contract and to seek damages for alleged concealment or misrepresentation in its inducement

> • • • it thus ratified both the substantive contract and the arbitration procedure which it embodied." *Nelley* v. *Baltimore City*, 166 A. 2d 234, 240 (1960).

This universal principle was recognized by Massachusetts in *Maxwell Shapiro Woolen Co.* v. *Amerotron Corp.*, 339 Mass. 252, 158 N. E. 2d 875, 879 (1959), when it held:

> "Shapiro has not sought to rescind the contracts, so we are not concerned with the effect of rescission upon arbitration."

It is readily apparent that the cases cited by F & C are non-authoritative, do not support its argument, and overwhelmingly support the position of Prima that rescission for fraudulent inducement is not referable to arbitration.

POINT V

The election of a remedy or a cause of action is legally determinative of validity, irrevocability and enforceability of an agreement.

The F & C characterization (Point III (B), Resp. Br. 28) as proper, of the Court below's erroneous finding of lack of distinction between equitable rescission and damages at law on contract, is entirely without merit. Negation thereof, regardless of the grossness of the fraud perpetrated, will result in complete abdication of judicial supervision, and shut the Courthouse door to the defrauded party.

Each and every relevant case cited in all the briefs reveal a meticulous examination into the cause of action asserted, in order to determine whether the action is in the nature of an affirmance of contract or whether it seeks rescission or repudiation of an agreement.

While a similar argument was rejected in *Robert Lawrence,* the result (not its holding) was proper, in view of the fact that the cause of action set forth in the complaint was *damages* for fraud in the inducement of the contract (Appendix 2-3, Docket No. 25209, Court of Appeals, 2d Cir.). Such an averment is in fact an affirmance of a contract. Additionally, the parties admitted in their briefs, that a *federal right* was involved.

It is noteworthy that, Judge Medina's theory, relied on by F & C (Resp. B- 29), is barren and devoid of reference or citation to any legal precedents.

This Court cannot fail to recognize, nor can it overlook an accepted and time-honored principle, that fraud permeates an entire agreement. This Court, in affirming the decision below and the *Robert Lawrence* doctrine, would be putting its imprimatur on a policy which would permit the judiciary, without legislative sanction, to abolish and obliterate common law causes of action (election of remedies) in diversity cases, obviously violative of Constitutional authority and the principals of *Erie* and its progeny.

POINT VI

Problems of restoration will not defeat equitable rescission.

Prima's claim for rescission is equitable in nature, and there is no requirement that Prima tender restoration prior to commencement of an action for equitable rescission. The extent to which Prima might be required to make restoration, as a condition to rescission, are questions to be determined at a hearing, not upon this review.

In *Marr* v. *Tumulty*, 256 N. Y. 15, 175 N. E. 356 (1931) the New York Court of Appeals (per Cardozo, C. J.) held that a complaint for rescission in equity was not defective because it did not embody an adequate tender of restoration. The Court observed that:

> "Equity is not crippled at such times by an inexorable formula. In exacting the return of benefits as a condition of rescission it proportions the exaction to the justice of the case before it. * * *
>
> * * * A different situation would be here if the action were at law upon the basis of a rescission already effectively declared. Instead, it is in equity to procure the declaration of a decision on whatever terms may be just (*Buffalo Builders Supply Co.* v. *Reeb, supra; Allerton* v. *Allerton*, 50 N. Y. 670; *Vail* v. *Reynolds*, 118 N. Y. 297, 302; *Thomas* v. *Beals*, 154 Mass. 51). Suitable conditions may be imposed by the decree (*Thomas* v. *Beals, supra; Allerton* v. *Allerton, supra;* American Law Inst. Restatement, Contracts, §98A)" (256 N. Y. at 21, 22).

And in *William Whitman Co.* v. *Universal Oil Products Co.*, 125 F. Supp. 137 (D. Del. 1954), a claim for equitable rescission was allowed even though specific restoration was impossible.

> "• • • rescission on the ground of fraud will not be denied because the exact benefits and advantages received by the defrauded party cannot, by reason of their nature, be restored, but the equities of the matter and justice to the parties will be moulded by the decree" (125 F. Supp. at 161-2).

F & C (Resp. Br. 33-34) relies upon *Lummus Company* v. *Commonwealth Oil Refining Co.*, 280 F. 2d 915 (1st Cir. 1960), *cert. denied* 364 U. S. 911 (1960) which had been decided only after lengthy hearings below (280 F. 2d at 930). In any event, we submit that *Lummus*, far from supporting F & C's position, stands for a contrary proposition and is inapposite. In the first instance, *Lummus* admittedly criticized *Robert Lawrence*, and its proposition was succinctly stated:

> "We hold that unless, by means of a proper claim for rescission, Commonwealth has put in issue the 'making of the contract,' it cannot by merely asserting fraud, stay the arbitration proceedings.
>
> • • • The principal thrust of the complaint • • • appears to be a tort action for damages" (280 F. 2d at 927).

It is abundantly clear therefore, that equity will mold its decree so that barren allegations concerning problems of restoration will not defeat equitable rescission.

POINT VII

This Court should wholly disregard F & C's Point IV.

A. F & C Raises a *de Novo* Argument

F & C urges this Court to affirm the order below alleging, first, Prima waived its right to rescind, and second, Prima never substantively demonstrated its claim of fraud below.

These arguments are entirely without the Record, are in violation of Supreme Court Rule 40 (1) (d) and are mere afterthoughts. This Court should not permit such arguments since they were never raised in any Court below, nor are they presented in the questions upon which certiorari was granted.

This Court has consistently refused to consider questions not raised or passed upon in the Courts below, (*Lawn* v. *United States,* 355 U. S. 339, 362, 2 L. Ed. 2d 321, 337, 78 S. Ct. 311 (1958); *Duignan* v. *United States,* 274 U. S. 195, 200, 71 L. Ed. 996, 1000, 47 S. Ct. 566 (1927), or mentioned in the petition for certiorari (*J. I. Case Co.* v. *Borak,* 377 U. S. 426, 12 L. Ed. 2d 423, 84 S. Ct. 1555 (1964); *Ryan* v. *United States,* 379 U. S. 61, 13 L. Ed. 2d 122, 85 S. Ct. 232 (1964); *Beck* v. *Washington,* 369 U. S. 541, 8 L. Ed. 2d 98, 109, 82 S. Ct. 955 (1962); cf. *Irvine* v. *California,* 347 U. S. 128, 98 L. Ed. 561, 74 S. Ct. 381 (1953).

The proceedings below conclusively establish that F & C continually relied upon, and the Courts below uniformly applied, the *Lawrence* theory of separability and concluded

as a *matter of federal law,* that issues of fraud, *regardless* of merit or substance, were referable to arbitration.

B. Respondent's Argument in Point IV Is Wholly Without Merit

F & C's legal precedents (Resp. Br. 35) asserted as determinative of its *de novo* argument, that prior to granting injunctive relief irreparable injury and reasonable probability of success must be shown, is completely inapposite. Without exception, the cases cited, involve actions under the Anti-Trust Acts, based upon 15 U. S. C. Section 26, which specifically requires such a demonstration.

Prima's original motion for a stay of arbitration was made pursuant to the Federal Rules of Civil Procedure which does not impose identical requirements.

1. No Waiver Was Committed by Prima

The Court should disregard F & C's assertion of waiver on Prima's part.

This plea, by way of confession and avoidance, was never raised below. Thus in effect, F & C now admits fraud had been perpetrated, but seeks to avoid its resulting legal impact. In assuming the burden of proving affirmative acts, F & C argues, that certain acts attributable to Prima are of sufficient magnitude to prevent Prima's election of the remedy of equitable rescission.

In every case cited by F & C (Resp. Br. 38) the party against whom waiver was successfully asserted had engaged in voluntary *affirmative acts,* thereby affirming the contracts.

F & C's newly formed theory of waiver is founded upon Prima's alleged *passive* "behavior in remaining silent" (Resp. Br. 37). To set forth Prima's contradictions would unnecessarily belabor this issue (Pet. Reply Br. 1-3, *supra*).

2. *Prima's Allegations Are Meritorious*

F & C maintained from the onset of these proceedings that the issue of fraud, *meritorious or otherwise,* is an issue referable to arbitration and not subject to preliminary judicial determination by the District Court. It would be an anomaly to allow F & C to argue that all issues of fraud are arbitrable and permit it the effrontery to suggest, indeed argue at length affirmatively, that Prima was not put to its proof of fraud below. F & C, through this apparent innovation and thin contrivance, belatedly seeks to argue a lack of substance to Prima's allegations of fraud. We submit these were and are issues the District Court should have determined upon a hearing.

CONCLUSION

For all of the reasons set forth herein and in the petitioner's main brief, it is respectfully submitted that the judgment of the court below be reversed.

Dated: New York, N. Y.
March 10, 1967

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BRIEF FOR PETITIONER IN OPPOSITION TO THE MOTION AND BRIEF OF THE AMERICAN ARBITRATION ASSOCIATION AS *AMICUS CURIAE*

POINT I

The Federal Arbitration Act was enacted by Congress based upon powers granted by Article III, Section I, of the Constitution.

The American Arbitration Association, which submitted a brief as *Amicus Curiae*, (hereinafter referred to as

"*Amicus*") and Prima agree that one of the traditional methods employed to answer a question of legislative basis for congressional enactments is to ascertain the *intent* of the framers of the legislation.

Contrary to the *Amicus* claim (*Amicus* Br. 4) there is sufficient historical background available to conclusively establish that the framers intended this Act to be merely procedural in its application and remedial in its scope.[1] The dearth, if any, is the almost complete absence of all reference to intended substantive effect.

Julius Henry Cohen, one of the leading authorities on Commercial Arbitration and a member of the American Bar Association Committee, sponsoring this legislation, at that time wrote "that enforcement of arbitration contracts is within the *law of procedure* as distinguished from substantive law is well established."[2] Further support that the legislative basis was Article III of the Constitution can be inferentially derived from the fact that the legislation originated in the Judiciary Committee of both Houses. References to interstate commerce and admiralty were evidently used to buttress the legislation,[3] since it

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[1] H. R. Rep. No. 96, 68 Cong., 1st Sess. (1924); S. Rep. No. 536, 68 Cong. 1st Sess. (1924); *American Airlines Inc.* v. *Country Air Board*, 269 F. 2d 811, 816 (6t Cir. 1959).

[2] Cohen & Dayton, The New Federal Arbitration Law, 12 Va. L. Rev. 266, 276 (1926) (Emphasis supplied).

[3] "Thus, despite criticism by commentators of the *Red Cross* case for its characterization of arbitration, congressional reliance on it in 1925 reflected the understanding that the Act was to regulate procedure in the federal courts, even though the commerce clause was relied on to buttress the Article III legislative base." Note 73 Harv. L. Rev. 1382, 1383 (1960).

is admitted that Congress has no power to legislate upon the validity of contracts generally. *Agostini Bros. Bldg. Corp.* v. *United States*, 142 F. 2d 854, 856 (4th Cir. 1944).

Bernhardt v. *Polygraphic Co. of America, Inc.*, 350 U. S. 198, 76 S. Ct. 273, 100 L. Ed. 199 (1956) does not support a proposition that the Federal Arbitration Act is substantive in its scope or application. *Bernhardt* clearly and admittedly *avoided such a holding* to escape the Constitutional problem it would have presented (350 U. S. at 202). To the contrary, the *Bernhardt* Court stated that "§§1 and 2 *define* the field in which Congress was legislating" (350 U. S. at 201, emphasis supplied). This holding that §2 is definitional in scope forecloses any possible consideration that §2 can have substantive application.

The *Bernhardt* Court characterized arbitration as a "remedy" and the Act as a "rule of procedure", in a case apart from the Federal Act (350 U. S. at 202, 203). No forceful reasons have been presented by Prima's opponents to require changing this characterization in a case within the Act.

It is patently clear that the *Bernhardt* decision was grounded upon the Constitutional limitation of *Erie*.[4] The *Bernhardt* view, that §3 unless restricted "would invade the local law field" manifests the conclusion that §2 would abuse and controvert this principle, if the position suggested by the *Amicus* were sustained.

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[4] "that Congress does not have the Constitutional authority to make the law that is applicable to controversies in diversity of citizenship cases." (350 U. S. at 202)

The *Amicus* disposes of the Constitutional question raised in Justice Frankfurter's concurring opinion in *Bernhardt* by casually claiming it would be non-existent if this Court characterizes §2 as substantive (*Amicus* Br. 6). Such a suggestion is erroneous.

Ever since *Guaranty Trust Co.* v. *York*, 326 U. S. 99, 65 S. Ct. 1465, 89 L. Ed. 2079 (1945), this Court has steadfastly followed a proposition that in a diversity case, any conflict between state and federal, law and policy, which will "significantly affect the result of a litigation" must be resolved in favor of state law and policy (326 U. S. at 109). To therefore label this Act substantive will not suffice to dispel the Constitutional problem remaining, whether the outcome of litigation of contracts containing an arbitration agreement will depend upon the Courthouse in which the action has been instituted, unless state law and policy is deemed to control the validity of such agreements.

Mere secondary authority supports the *Amicus* proposition that the New York Statute has been analyzed as "changing the substantive law of arbitration in New York as well as providing a new remedy" (*Amicus* Br. 8, n. 4). Conversely, the New York cases cited by Prima (Pet Br. 17) are the controlling precedents on this subject.

The *Amicus*, in an effort to find a substantive intent on the part of the Act's framers, relies upon a comment made in a sub-committee hearing, held fully two years before the Bill's passage (*Amicus* Br. 8-9). The *Amicus* omits those statements made in the Congressional Record and in the House and Senate reports [5] at the time of the Bill's

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[5] See note 1 *supra*; 65 Cong. Rec. 1931 (1924).

passage which clearly indicate that the Act was intended to be procedural, and the feeling of contemporary writers that such was the legislative intent.[6]

The damaging *dicta* of Judge Medina in the *Robert Lawrence* case, that the Act did not furnish an independent basis of federal jurisdiction, is inverted by the *Amicus* who by sheer sophistry concludes that it proves the Act's substantive nature (*Amicus* Br. 9). The irrefutable denial by Judge Medina of a substantive application of the Act, contrasted with the inductive sleight-of-hand applied by the *Amicus*, cannot compel a conclusion that the Act was meant to be substantive.

Desperately the *Amicus*, seeking to reinforce this mystical reasoning, seizes upon a single sentence[7] which fixes the effective date and denies retroactive effect to the Act, declaring that "If only a rule of procedure in the federal courts were at issue, there would have been no reason to deny the Act retroactive effect" (*Amicus* Br. 9). Rule 86 of the Federal Rules of Civil Procedure rebuts this thesis since it, in substance, also denies retroactive effect to the Federal Rules of Civil Procedure.

A specious rationale is then conjured by the *Amicus* that no permissible inference can be drawn from the complete absence of any expressed intent in the Act that it be applicable to state court actions (*Amicus* Br. 9). Moreover, the *Amicus* urges that this absence of a specific intent is not of particular significance (*Amicus* Br. 10).

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[6] See note 9, Petitioner's main brief.

[7] 9 U. S. C. §14.

It is axiomatic that silence as well as expression may be determinative of legislative intent. This admitted Congressional silence is susceptible of a single inference, that is, lack of intent to make the act applicable to state court actions.

For the reasons stated, the conclusion is inescapable, that §2 of the Arbitration Act must be held procedural in its application when jurisdiction is founded *solely* upon diversity of the parties.

POINT II

An arbitration clause in a contract does not exist as a separable special agreement and a question of fraud in the inducement, challenging the validity of the entire contract, must be determined in the first instance judicially.

Prima and the *Amicus* agree that the first issue to be determined is the contractual intent of the parties. From this point on, the reasoning of Prima and the *Amicus* depart.

The *Amicus* claims that Prima misconstrues the purpose underlying the inclusion of a broad arbitration clause, because such a clause indicates a "conscious judgment" of the parties to arbitrate (*Amicus* Br. 16). The fallacy inherent in this hypothesis is that the existence of fraud in the inducement of a contract contradicts the supposition of any conscious act, even to arbitrate. Such an allegation negates in the first instance any meeting of the minds. To fortify this faulty premise, the *Amicus* neces-

sarily requires that the Judiciary reject the concept of the integral nature of a contract.

The imposition of the *Amicus'* so-called "rule of legal necessity" will defeat any judicial test of the alleged "conscious judgment" of the parties (*Amicus* Br. 16-18). Once a party is duped into signing a contract which includes a broad arbitration clause, arbitration will follow regardless of the grossness of the fraud perpetrated. See *Mosley* v. *Electronic & Missile Facilities, Inc.*, 375 U. S. 167, 84 S. Ct. 1815, 10 L. Ed. 2d 818 (1963).

In admitting that "It may well be true that the parties did not contemplate fraud", the *Amicus* loses sight that "any other particular kind of dispute" refers to disputes which usually *arise out of* or *concern* the contract (*Amicus* Br. 14). Fraud, however, denies the entire contract's very existence.

Notwithstanding the *Amicus'* contention that a commercial arbitrator possesses power to grant rescission, this Court has, in *Bernhardt* already ruled positively, forcefully, and without contradiction that:

> "The change from a court of law to an arbitration panel may make a radical difference in ultimate result. Arbitration carries no right to trial by jury that is guaranteed both by the Seventh Amendment and by Ch. 1, Art. 12th of the Vermont Constitution. Arbitrators do not have the benefit of judicial instruction on the law; they need not give their reasons for their results; the record of their proceedings is not as complete as it is in a court trial; and judicial review of an award is more limited than judicial review of a trial—all as discussed in Wilko v Swan,

346 US 427, 435-438, 98 L ed 168, 175-177, 74 S Ct 182." (350 U.S. at 203).

A different outcome may result if Prima is relegated to arbitrate the question of fraud in the inducement. Arbitration is different than a trial before a court, therefore it is facetious to argue that there is no resultant loss of remedy, since Prima, as stated in *Bernhardt* will lose "an important part of the parcel of rights" that are behind its election (350 U. S. at 203). Forbidding Prima access to a court of law results in the destruction of its inherent right to elect a remedy.

To impose a requirement of preliminary judicial determination, which §4 of the Act itself provides, can hardly constitute emasculation of the Arbitration Act nor can it herald the renaissance of the old common law hostility to arbitration. Surely judicial determination of the validity of agreements was meant to be preserved by the framers of this legislation.

CONCLUSION

For all of the reasons set forth herein and in the petitioner's main brief, it is respectfully submitted that the judgment of the court below be reversed.

Dated: New York, N. Y.
March 10, 1967

ROBERT P. HERZOG,
Attorney for Petitioner
Prima Paint Corporation.

Of Counsel:
JULES TEITELBAUM,
GRACE L. BRODSKY.

APPENDIX A

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

65 Civ. 1413

SHERWIN ROBERT RODGERS, and SHERWIN ROBERT RODGERS ASSOCIATES, INC., an Illinois Corporation,

Plaintiffs,

against

LAWRENCE FELDMAN and LARBETH MANAGEMENT, INC., a New York Corporation,

Defendants.

APPEARANCES:

PHILIP HANDELMAN, ESQ.,
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LAWRENCE M. POWERS, ESQ.,
Of Counsel.

LAURENCE FELDMAN, ESQ.,
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WYATT, District Judge.

Appendix A

This is a motion by plaintiffs to stay arbitration demanded by defendants under a written contract dated February 26, 1965.

Plaintiffs commenced this action on May 10, 1965 seeking (1) damages suffered by plaintiffs because of an alleged fraudulent scheme in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934; and (2) rescission of the February 26, 1965 contract on the ground that plaintiffs were fraudulently induced to make that contract by "material misstatements of fact and * * * misleading omissions of fact" of defendants (Complaint para. 3).

The prayer for relief in the complaint does not in terms demand rescission but it is clear that the position of plaintiffs is that they have already rescinded for fraud and are entitled to have back the $21,000 claimed to have been given up by them or that they are entitled to rescission in this action. Demand for rescission is in para. 11 of the complaint.

Jurisdiction of this Court is based on (1) a federal question (28 U. S. C. §1331) and (2) diversity of citizenship between the parties (28 U. S. C. §1332). The amount in controversy exceeds $10,000.

Copies of the February 26, 1965 contract are attached to the complaint and to the moving affidavit.

Paragraph 15 of the contract is as follows:

> "In the event of any dispute or disagreement between the parties hereto which they are unable to

amicably resolve, the same shall be submitted to arbitration by the American Arbitration Association of New York, New York City pursuant to the rules of said association. The decision of an arbitrator or arbitrators designated by said association shall be final, binding and conclusive upon the parties hereto."

On May 14, 1965, three days after levies had been made under an attachment granted in this action, the American Arbitration Association at New York received a demand for arbitration by the defendants.

The theories for the movants in seeking a stay of arbitration are (1) "a suit based upon the Federal securities statutes may not be stayed to compel a plaintiff to submit his claim of fraud in the inducement to arbitration" on the authority of *Wilko* v. *Swann*, 346 U. S. 427 (1953); and (2) under New York law, applicable to that part of the action seeking rescission of the contract, fraud in the inducement is not an issue to be arbitrated under an arbitration clause in the contract sought to be rescinded.

Without passing on the first theory, it seems clear that the second theory is sound and that the motion must be granted.

In testing the second theory, New York law applies (and not federal law) because the claim to rescission is based on diversity jurisdiction and the parties appear to agree that there is not involved a "maritime transaction or a contract • • • involving commerce" (9 U. S. C. §2). See *Robert*

Appendix A

Lawrence Co. v. *Devonshire Fabrics, Inc.*, 271 F. 2d 402, 404-408 (2d Cir. 1959), cert. dismissed 364 U. S. 801 (1960).

Under Civil Practice Law & Rules ("CPLR") §7503(b) of New York, a party may apply to stay arbitration on the ground that "a valid agreement was not made". A New York court will stay arbitration where rescission of the contract containing the arbitration clause has been sought on the ground that fraud induced the making of the contract.

Professor Corbin states the principle in this way:

> "The fraud of one party, inducing the other's assent to the whole [contract] makes the whole [contract] voidable at the latter's option; after a proper avoidance, the right to an arbitration falls along with all other rights created by the other promises that were made. In cases within this paragraph, the remedies for enforcement of arbitration agreements are not available, including the enforcing order authorized by an arbitration statute. Before issuing such an order the court must know that a legal duty to arbitrate exists; this is an issue that the court itself must decide." 6A Corbin on Contracts §1444, p. 449 (1962).

In *Robert Lawrence Co.*, above cited, Judge Medina found that New York law was in accord with the foregoing quotation but that federal law under the Federal Arbitration Act differed from New York law (271 F. 2d at 412). According to Judge Medina, the agreement to arbitrate clause is (under federal law) to be considered

as separate and apart from the rest of the contract and arbitration may be stayed only where there is a substantial claim that "this arbitration clause was induced by fraud" (271 F. 2d at 402). See 6A Corbin, above, pp. 465-66. The Court in *Robert Lawrence Co.* found as a fact that the arbitration clause—considered apart from the rest of the contract—was not induced by fraud.

Decisions by the Court of Appeals of New York do not separately consider the arbitration clause and the rest of the contract in determining the effect of fraud in the inducement upon the right to arbitration or to a stay of arbitration.

In *Wrap-Vertiser Corp.* v. *Plotnick*, 3 N. Y. 2d 17 (1957), Plotnick and Wrap-Vertiser Corp. ("Wrap") made a distribution contract under which Wrap was to supply equipment and supplies for sale by Plotnick, who when the contract was executed paid $6,000 to Wrap as an advance against deliveries to be made. The contract made arbitration compulsory for any question "as to the validity, interpretation or performance of this agreement". Disputes arose, Plotnick claiming to be the injured party by reason of failure of Wrap to supply good equipment and of fraud by Wrap inducing the agreement, such fraud being misrepresentations as to the products involved, the past experience of Wrap, and ownership by Wrap of a certain patent. Plotnick demanded arbitration of his claims. Wrap then moved the New York Court to stay arbitration of the claim of fraud in the inducement. A

Appendix A

Majority of the Court of Appeals decided that such a stay was proper because the issue of fraud in the inducement was not within the terms of the arbitration clause—was not a question "as to the validity, interpretation or performance of this agreement". The three dissenting justices believed that the fraud issue was within the language of the arbitration clause. The decision and this difference between the judges (which are of no significance in the case at bar) came about because (unlike the case here) Plotnick was *not* asking *rescission* of the contract but was standing on the contract. As to this, the majority declared (3 N. Y. 2d at 19, 20):

> "He [Plotnick] has not rescinded nor does he seek rescission either alone or in conjunction with damages. He has elected to affirm the contract and bases his contentions upon its binding force, as Justice Botein's dissenting opinion states at the Appellate Division. If he were seeking rescission, none of the items in his arbitration demand could be arbitrated until the issue of rescission had been determined in the courts. * * * No question of validity of the contract is at stake inasmuch as Plotnick has chosen to stand upon the agreement and does not seek rescission. Even if he had rescinded or asked for rescission, such an issue would have had to have been decided in court before it could be known that an agreement existed supplying a foundation for the jurisdiction of the arbitrators."

Nothing in the dissent disputed the principle stated in the quoted language of the majority. While dicta, the lan-

guage reflects the unanimous view of the Court of Appeals that where rescission for fraud is demanded, as in the case at bar, such fraud issue may not be arbitrated.

An arbitration clause much broader than in *Wrap-Vertiser* was before the courts in a case cited for defendants—*Amerotron Corp.* v. *Maxwell Shapiro Woolen Co., Inc.*, 3 A. D. 2d 899 (1st Dept. 1957), affirmed 4 N. Y. 2d 722 (1958). The fraud claim was within the *broad terms* of the arbitration clause and thus arbitration could not be denied, as had been done in *Wrap-Vertiser*, because of the wording of the arbitration clause. Arbitration of the fraud claim was held proper. The decision is no authority whatever for defendants since in *Amerotron*, like *Wrap-Vertiser* but unlike the case at bar, rescission had not been demanded. The point was carefully noted: "* * * respondent failed to rescind the contract and elected to recognize the contract and claim damages for the fraud" (3 A. D. 2d at 899).

Judge Fuld later stated the policy of New York to be that "where parties enter into an agreement and, in one of its provisions, promise that any dispute arising out of or in connection with it shall be settled by arbitration, any controversy which arises between them and is within the compass of the provision must go to arbitration." *Exercycle Corp.* v. *Maratta*, 9 N. Y. 2d 329, 334 (1961). He then made plain that such a case as that at bar fell outside this policy. "As exceptions to this general policy, however, we have held that a court will enjoin arbitra-

tion * * * where fraud or duress, practiced against one of the parties, rendered the agreement voidable * * *" (9 N. Y. 2d at 334). Of course, Judge Fuld meant that arbitration in such cases would be enjoined *if* the party claiming to be defrauded had demanded rescission; as we have seen, if the injured party elects to stand on the agreement he may not at the same time enjoin enforcement of an arbitration clause in that agreement.

It remains to notice *Fabrex Corp.* v. *Winard Sales Co.*, 200 N. Y. S. 2d 278 (Special Term, N. Y. County, 1960), cited for defendants. The decision might be distinguished on the ground that the fraud there claimed was not an inducement for the agreements but "relates solely to the question of performance under the contracts" (200 N. Y. S. 2d at 280). If not so distinguishable, then the decision must be considered, with great deference, to be wrong.

For the reasons indicated, the motion is granted and the arbitration demanded by defendants under the contract of February 26, 1965, is hereby stayed pending final determination of this action.

So Ordered.

Dated: New York, New York
August 24, 1965

Inzer B. Wyatt
United States District Judge